PILLSBURY WINTHROP SHAW PITTMAN LLP
REYNOLD L. SIEMENS #177956
Email: reynold.siemens@pillsburylaw.com
725 South Figueroa Street, Suite 2800
Los Angeles, CA 90017-5406
Telephone: (213) 488-7100
Facsimile: (213) 629-1033

PILLSBURY WINTHROP SHAW PITTMAN LLP
BRUCE A. ERICSON #76342
Email: bruce.ericson@pillsburylaw.com
GEORGE ALLEN BRANDT #264935
Email: allen.brandt@pillsburylaw.com
50 Fremont Street
Post Office Box 7880
San Francisco, CA 94120-7880
Telephone: (415) 983-1000
Facsimile: (415) 983-1200

Attorneys for Defendants ROBERT JOHN BURRELL, WILLIAM CHENEY, GORDON DAMES, ROBERT H. HARVEY, JR., JAMES JORDAN, TIMOTHY M. KRAMER, ROBIN LENTZ, JOHN M. MERLO, WARREN NAKAMURA, BRIAN OSBERG, DAVID RHAMY and SHARON UPDIKE

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

WESTERN DIVISION

NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION,

Plaintiff,

vs.

ROBERT A. SIRAVO, et al.,

Defendants.

No. CV 10-01597 GW (MANx)

MEMORANDUM IN SUPPORT OF DIRECTOR DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S SECOND AMENDED COMPLAINT (DOC. 116)

Honorable George H. Wu
Courtroom 10
312 North Spring Street

Date: June 9, 2011
Time: 8:30 a.m.
Courtroom: Los Angeles, 10

Filed herewith:
1. Notice of Motion and Motion
2. Request for Judicial Notice

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I. INTRODUCTION.

The Court has given the NCUA ample guidance on how to plead facts establishing an exception to the Business Judgment Rule. The Second Amended Complaint, Doc. 116 ("SAC") demonstrates that the NCUA either can't or won't follow that guidance. While offering more verbiage, the SAC still relies mainly on hindsight-fueled allegations about the *content* of the Directors' investments decisions. And, on the relatively few occasions where the SAC discusses the Directors' *process*, it fails to meet the standards delineated by the Court and by *Lee v. Interinsurance Exchange*, 50 Cal. App. 4th 694, 715, 717, 57 Cal. Rptr. 2d 798, 811-13 (1996).

The SAC's content-based allegations boil down to the unremarkable proposition that, in hindsight, WesCorp would have fared better had it bought fewer private-label mortgage-backed securities ("MBS") or unloaded them sooner. Hindsight is, as the cliché goes, 20/20. But hindsight cannot overcome the Business Judgment Rule. And in this case, the NCUA's own admissions undercut whatever minimal effect hindsight might otherwise have. For the NCUA, in its own words, has admitted that *at the time* everyone – the NCUA included – 'knew' private-label MBS to be a low-risk investment permitted by the NCUA's enabling statute and rules, and just as safe as the MBS issued by government sponsored enterprises such as Fannie and Freddie.

The SAC alleges that WesCorp's Budget Committee paid too little attention to the risk said to be inherent in the level of income it budgeted. But nothing in the SAC shows that risk-assessment fell within the Budget Committee's purview. The Court pointedly asked for allegations showing that the Budget Committee had jurisdiction over risk-assessment; the SAC provides exactly nothing. Instead, the SAC alleges that another committee – the Asset & Liability Committee ("ALCO") – assessed risk, and met regularly with the Budget Committee. The SAC alleges nothing – and certainly nothing satisfying

Lee – to suggest that the Budget Committee should have duplicated the ALCO's work, or would have discovered anything material had it done so.

The SAC alleges that WesCorp's Option ARM MBS performed poorly – in hindsight – and had deficiencies. But once again the SAC fails to connect this to anything that the Directors knew at the time, or could have discovered by more investigation. Instead, the SAC offers the conclusory allegation that Option ARMs were "new" – a claim that legal authorities show to be demonstrably wrong – and suggests that their "newness" called for further investigation. Again these allegations come nowhere near satisfying *Lee*.

The SAC also alleges that the Directors did enough investigation to see storm clouds on the economic horizon, but failed to unload WesCorp's MBS fast enough to avoid the storm. Here, in one set of allegations, we have both an admission of adequate process (you investigated enough to see the storm clouds) and a legally irrelevant attack on content (in hindsight, you did not dump your MBS fast enough). And that is not all that is wrong with what the SAC alleges. The SAC finds recognition of these storm clouds in books prepared each month for the ALCO. But having expressly mentioned these books – thus making them fair game for judicial notice – the SAC ignores 90% of what they say. The books reveal a detailed monthly process, examining concentration limits, risk, capital, delinquency rates, losses and credit support, among many other things. The books also reveal timely changes in investment strategy in response to changes in economic climate and risk. Yet the SAC mentions none of this – citing the books repeatedly but conveniently ignoring what they say.

Most of all, the SAC consists of retreads – old allegations made fatter but in no material way made better. That is true of the allegations about capital; that is true of the allegations about buying lower tranches of AAA-rated investments. And that also is true of the allegations about concentration limits, credit spreads and losses. There is not a hint of real novelty in any of this.

In short, the SAC, like the First Amended Complaint, Doc. 84 ("FAC"), fails to allege an exception to the Business Judgment Rule. Back in the day, the NCUA had two examiners on site at WesCorp, with real-time access to WesCorp's investment decision-making. Since 2009, the NCUA has controlled all of WesCorp's books and records. Yet today the NCUA is no closer to stating a claim than when it started this crusade against unpaid, uninsured volunteer directors – directors who never took a dime out of WesCorp for themselves; directors who entrusted WesCorp with millions of dollars of their own credit unions' money. Enough is enough. The claims against the directors should be dismissed without further leave to amend.

II. STATEMENT OF THE CASE.

A. The parties.

Plaintiff: We have a new plaintiff, albeit not one that has complied with Fed. R. Civ. P. 25(c) (that noncompliance is the subject of a separate motion). The National Credit Union Administration Board as *Conservator* of WesCorp filed the FAC. But the National Credit Union Administration Board as *Liquidating Agent* of WesCorp filed the SAC. While the two plaintiffs are not the same, for purposes of this motion we shall call them both the "NCUA."

Defendants: The 16 named defendants are some but not all of the former directors and officers of WesCorp. SAC ¶¶ 7-22. The movants here are 11 former unpaid uninsured volunteer directors (the "Directors"). *Id.* The Directors are named only in the Second, Third and Fourth Claims (the "Investment Claims"), which this motion seeks to dismiss. The five officers are filing separate motions to dismiss the claims asserted against them.

B. Procedural history.

In March 2009, the NCUA took over WesCorp and placed it into a conservatorship; in October 2010, it began an involuntary liquidation. SAC ¶ 1. The seven original plaintiffs filed this case in superior court in November 2009.

The NCUA intervened and removed the case to this Court. Doc. 1. The NCUA and the original plaintiffs disputed who owned the claims and should control the litigation (Doc. 31, 40-43); the Court ruled largely in favor of the NCUA (Doc. 66). After further proceedings (Doc. 80-81), the NCUA filed the FAC and the original plaintiffs withdrew from the case (Doc. 84-85). Defendants filed motions to dismiss the FAC on November 1, 2010. The Court said it was inclined to grant the Directors' motion to dismiss without leave to amend but let the NCUA submit an offer of additional allegations (Doc. 110). After additional briefing, the Court stated that granting leave to amend was "a close call" but allowed the NCUA to amend (Doc. 115). Hence the SAC.

Unlike the usual private plaintiff, who must prepare a complaint with little or no access to the defendants' records, the NCUA had daily access to WesCorp's books and records – and to its employees – for a year and a half before it filed the First Amended Complaint ("FAC") and six more months before it filed the SAC. The NCUA thus has had two opportunities to allege facts establishing an exception to the Business Judgment Rule. Having had ample time and opportunity to investigate its claims, the NCUA has no excuse for not filing a detailed and specific complaint satisfying *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009). But the SAC does not satisfy *Twombly* and *Iqbal*.

C. The SAC's allegations about the Investment Claims.

The FAC's Investment Claims failed because they did not establish an exception to the Business Judgment Rule. The FAC offered almost exclusively hindsight disagreements with the *content* of the Directors' decisions. *See* Doc. 110 ("12/20 Order") at 7 ("Plaintiff essentially concedes that most of its allegations deal with content instead of process."). The FAC conceded so much about what the Directors did right that its few allegations not based on hindsight bias could not overcome the Business Judgment Rule. *Id.* at 9.

The SAC fares no better. Its "new" allegations fall into three categories: allegations that WesCorp's Budget Committee did not monitor investment risk; allegations that WesCorp imprudently approved investing in Option ARMs; and allegations about the reports on economic and market conditions prepared by WesCorp's staff and reviewed each month by WesCorp's ALCO. *See* Doc. 115 ("1/31 Order") at 2. These "new" allegations do not give the Court what it asked for: *factual* allegations demonstrating a failure to conduct an active investigation in circumstances where facts known to the Directors reasonably called for an investigation or where an investigation would have revealed facts material to the questioned exercise of business judgment. 12/20 Order at 7. Indeed, the SAC suffers from the same fundamental problem as the FAC: it also mainly uses hindsight to attack the content of the Directors' decisions while making numerous admissions about what the Directors did right.

III. ARGUMENT.

Dismissal is appropriate wherever a plaintiff has failed to plead facts to state a claim for relief that is "plausible." 12/20 Order at 2 (quoting *Johnson v. Riverside Healthcare Sys., LP,* 534 F.3d 1116, 1121-22 (9th Cir. 2008)). Like the FAC, the SAC fails to state "plausible" Investment Claims because it does not plead facts establishing an exception to the Business Judgment Rule.

A. The NCUA must meet an extremely high standard to overcome the Business Judgment Rule.

Claims 2, 3 and 4 purport to allege breaches of fiduciary duty, namely, the duty of care. California law applies to such claims. 12/20 Order at 4.

California's Business Judgment Rule, codified in part at sections 309 and 7231 of the California Corporations Code, "recognizes that where decisions are without fraud or breach of trust, 'management of the corporation is best left to those to whom it has been entrusted, not to the courts.'" 12/20 Order at 5 (quoting *Bader v. Anderson*, 179 Cal. App. 4th 775, 787, 101 Cal. Rptr. 3d 821,

830 (2009)). Absent one of its limited exceptions, "the rule . . . protect[s] well-meaning directors who are misinformed, misguided, and honestly mistaken." *Id.* (quoting *FDIC v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1999)). The Rule prohibits courts from interfering in business decisions made by directors in good faith and in the absence of a conflict of interest. *Id.* (citing *Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1045, 100 Cal. Rptr. 3d 875, 897 (2009)). "[D]oubtful cases" do not call for "[i]nterference with the discretion of directors." *Id.* at 5-6 (quoting *Berg & Berg*, 178 Cal. App. 4th at 1046; *Lee*, 50 Cal. App. 4th at 715).

The exceptions to the Business Judgment Rule are limited. To plead an exception, a plaintiff must plead facts establishing a conflict of interest, fraud, oppression, corruption or a complete abdication of corporate responsibility. 12/20 Order at 6 (citing *Castetter*, 184 F.3d at 1046). "[T]o establish such exceptions, conclusory allegations of improper motives or conflict of interest are insufficient, as are general allegations of a failure to conduct an 'active investigation, in the absence of (1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment.'" *Id.* (quoting *Lee*, 50 Cal. App. 4th at 715). Because of the distorting effects of hindsight bias, the Business Judgment Rule permits courts and juries to examine only the process by which directors made decisions, and not the content of the decisions. *See id.* at 7; *see also In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 127 (Del. Ch. 2009). "To rebut the presumption afforded by the business judgment rule, most of the time only affirmative allegations demonstrating fraud, bad faith, overreaching or an unreasonable failure to investigate material facts will do." 12/20 Order at 6 (citing *Berg & Berg*, 178 Cal. App. 4th at 1046; *Lee*, 50 Cal. App. 4th at 715).

Here, the SAC alleges no facts calling into question the Directors' motives or honesty. Just as "[f]raud, breach of trust, conflict of interest, bad faith, oppression, corruption, complete abdication of responsibility, willful ignorance and gross overreaching are fairly glaringly absent from the allegations" in the FAC (*id.* at 8), so too are they "fairly glaringly absent" from the SAC.

Absent such allegations, the SAC must allege an unreasonable failure to investigate material facts, within the meaning of *Lee*. Yet the SAC's allegations do not meet this standard, particularly viewed in light of the NCUA's admissions about the Directors' decisions and decision-making processes.

B. The NCUA's admissions defeat its Investment Claims.

The NCUA admits that WesCorp only purchased securities that Moody's or Standard & Poor ("S&P") rated AAA or AA, the two highest ratings available. 12/20 Order at 8; SAC ¶ 82. The NCUA also admits that WesCorp bought mainly AAA-rated securities and began to decrease its holdings of AA-rated securities in 2005, well before the market collapse. 12/20 Order at 8; SAC ¶¶ 73, 82. The NCUA gave corporate credit unions the power to invest in securities rated "AA-"(12 C.F.R. § 704.6(d)(2) (Oct. 25, 2002)) and gave WesCorp expanded authority to invest in securities rated as low as "BBB" (12 C.F.R. Part 704, Appx. B (Oct. 25, 2002)). On S&P's ratings scale, BBB is six levels below AA (the levels in between are AA-, A+, A, A- and BBB+). Yet despite the NCUA's invitation, WesCorp never bought these lower-rated securities, never held less than 78% AAA-rated securities, ceased buying subprime late in 2006 and ceased buying private-label MBS altogether in July 2007. SAC ¶ 146.

The Court recognizes that the fact that WesCorp purchased only the highest rated assets presents "a seemingly gigantic problem with Plaintiff's case . . . ." 1/31 Order at 2. Indeed it does. WesCorp's AAA-rated assets received the top rating because independent ratings agencies deemed them the highest quality assets available to investors, and among the safest. This is not just what

the Director and the ratings agencies thought, it is what the NCUA publicly stated as late as a month or two before it filed the FAC. In a video about corporate credit unions – including WesCorp – publicly distributed to credit unions last summer and still available on the Internet in both video and transcribed form, the NCUA made these statements, among many others:

- "Historically mortgage-backed securities experienced no significant losses . . . ." [1]
- "Historically, mortgage-backed securities fit well into the corporate credit unions' business function as a liquidity provider because there was an active market for mortgage-backed securities and they could be used as collateral for borrowing." NCUA Transcript at 7, RJN Ex. 10, at 0765.
- "When corporate credit unions had excess funds on deposit from consumer credit unions who were their members, some purchased private-label mortgage-backed securities with those funds. **The securities offered a better return and were historically just as safe as many other investment products.**" *Id.* (emphasis added).
- "When the investment requirements for Part 704 [that is, 12 C.F.R. Part 704, the NCUA's regulations for corporate credit unions, none of which WesCorp is alleged to have violated] were implemented, a thorough review was performed on the history of credit ratings and their success in evaluating the financial strength of marketable securities. **The loss history of securities with an initial rating of triple-A or double-A was less than one half of one**

[1] NCUA, Transcript of Corporate System Resolution Presentation, Track 2, http://event.on24.com/event/22/07/64/rt/1/documents/player_docanchr_1/transcriptforchapter2.pdf (last visited Jan. 23, 2011), at 6, Request for Judicial Notice, filed herewith ("RJN"), Ex. 10, at 0764. A video version of the NCUA's presentation may be found on its website at http://www.ncua.gov/Resources/CorporateCU/CSR/Presentations.aspx (last visited Jan. 19, 2011).

percent. The loss history of securities issued by government-sponsored entities and the loss history of private label securities was virtually the same." *Id.* (emphasis added).

- "While corporate credit unions were not allowed to rely only on credit ratings, the track record of credit ratings in evaluating the future performance of securities was historically strong. Credit ratings have been an investment decision-making tool in financial markets for decades." *Id.*
- "All of the mortgage-backed securities that were purchased by corporate credit unions were permissible at the time they were acquired and accordingly met the rating requirements." *Id.*
- "**Based on historic performance, there appeared to be very little risk with the private label mortgage backed securities purchased by the corporates.**" *Id.* at 0766 (emphasis added).
- "Finally, many of the securities paid interest based on a floating rate rather than a fixed rate. This helped corporate credit unions in the overall management of their investment and share portfolios, and mitigated the risk of changing interest rates." *Id.*

These admissions render the SAC's allegations about the *content* of the Directors' investment decisions implausible under *Twombly* and *Iqbal*, to put it mildly. But the NCUA's admissions do not stop there: they also undercut the SAC's allegations about *process*. Thus, whatever the wisdom of making investment decisions solely on the basis of ratings obtained from a "Nationally Recognized Statistical Rating Organization" (*see* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, and 17 C.F.R. § 240.17g-1 et seq. (June 18, 2007)) such as S&P or Moody's, it is clear that the Directors did not rely solely on credit ratings and did much more investigation. The original complaint alleges that WesCorp hired an independent third-party consulting and valuation firm called RiskSpan Inc. to evaluate each of WesCorp's investments

monthly. Doc. 1, Orig. Compl. ¶¶ 4-5, 16.[2] The SAC expressly mentions the books that ALCO members received each month before the monthly ALCO meeting. *E.g.*, SAC ¶¶ 97, 99, 138-42. But the SAC is exceedingly selective in what it says about these books. The SAC notes, for example, that the books typically survey economic and market conditions. *See*, *e.g.*, SAC ¶ 97, referring to part II of the ALCO book for April 2006, *see* RJN Ex. 1, at 0022-33. But the SAC conveniently omits to mention that the ALCO books also contain a consent agenda listing each proposed new investment, with individualized concentration limits as to each (*id.* at 0013-20), a detailed discussion of risk assessment and risk exposure (*id.* at 0035-48), a detailed discussion of fluctuations in member balances and loans (*id.* at 0050-55), a detailed forecast of borrowings, liquidity and capital (*id.* at 0057-67), a discussion of investment strategies, including a list of all transactions in the previous month (*id.* at 0069-73), and supporting documentation that includes pages upon pages of detail on derivatives, concentration limits, watch lists, counterparty transaction limits, delinquencies, losses, credit support and stress tests analyzing various risk scenarios (*id.* at 0075-0107). All of these sections are supported by pages of raw data. *Id.* And this is just one month's book. All the other books cited by the SAC contain this much detail or more. *See* RJN Ex. 1, 4-9. These books – cited by the SAC and thus fair game for judicial notice – belie the SAC's conclusory claim that the Directors ignored risks and stinted on process.

But that is not all. The NCUA also admits that: All of WesCorp's investments were underwritten "by the world's leading investment banks." SAC ¶ 39. WesCorp's budgets contained "detailed information" including proposed

[2] The original plaintiffs alleged that RiskSpan performed that work negligently, but the NCUA chose not to pursue such allegations and dropped RiskSpan from the case. Thus, we are left with the allegation that WesCorp hired and relied in part on risk assessments performed by an independent expert. Directors may rely on independent expertise. 12/20 Order at 4-5.

projected expenses, projected fee income, and monthly projected totals for projected investment income. SAC ¶ 88. WesCorp classified and tracked MBS investments by rating (AAA and AA) and FICO score (prime, alt-A and subprime). SAC ¶ 128. And the Directors "generally" attended ALCO meetings and received presentations about the state of the economy, the investment climate and WesCorp's investment strategy. SAC ¶¶ 96, 97, 99, 135.

These admissions have not significantly changed from the admissions in the FAC. And, as in the FAC, "[t]he affirmatively-alleged facts about what the Director Defendants *did do* in their roles with WesCorp are not meaningfully different from those the Ninth Circuit considered in *Castetter* and concluded called for application of the business judgment rule." 12/20 Order at 9 (citing *Castetter*, 184 F.3d at 1045).

Given the NCUA's many admissions about what the Directors did right, the NCUA needs substantial factual allegations about what the Directors did wrong – within the meaning of *Lee* – to plead an exception to the Business Judgment Rule. As shown below, the SAC offers no such allegations.

C. The SAC's "new" allegations do not plead an exception to the Business Judgment Rule and do not cure the problems the Court identified with the FAC.

The "new" allegations that the NCUA pleads in the SAC fall into three categories: allegations about the Budget Committee; allegations about approval of Option ARM investments; and allegations about surveys of economic and market conditions in the ALCO books. None differs significantly from the allegations of the FAC and none pleads an exception to the Business Judgment Rule. *See* 1/31 Order at 2 (most of the new allegations in the NCUA's Offer of Additional Allegations, Doc. 111, "are not significantly different than what were already included in the FAC.").

1. The SAC's allegations about the Budget Committee fail to overcome the Business Judgment Rule because they do not show the Committee failed unreasonably to investigate matters within its purview.

The SAC alleges that the Directors who served on the Budget Committee failed to monitor the risk in WesCorp's portfolio. *See* SAC ¶¶ 85-104. (These allegations form the basis for the Second Claim against the Directors who served on the Budget Committee. SAC ¶¶ 199-205.) The SAC claims that the Budget Committee adopted budgets that mandated a particular level of investment income without adequately investigating how much risk WesCorp would have to run to achieve that level of investment income. *See, e.g.*, SAC ¶ 89.

But the SAC offers no facts that explain why a *Budget Committee* should be held responsible for analyzing investment decisions, particularly when that task fell to others – *e.g.*, the ALCO. SAC ¶ 25. This is an enormous hurdle for these allegations, because "the Court would seemingly also have to question why a *budget* committee should be held responsible for the effect of *investment* decisions." 1/31 Order at 2 (emphasis in original). The Court asked this question; the SAC offers no allegations that answer this question. All it offers are conclusory allegations in support of a dubious syllogism: the budgets set a level of investment income; that level of income required a certain level of risk; and in hindsight the particular risks that the Directors decided to take did not work out. Even without the Business Judgment Rule, the SAC's allegations about the Budget Committee are too conclusory and tenuous to form the basis of a claim for breach of the duty of care, because they do not begin to show that risk assessment fell to the Budget Committee.

Even if the SAC could task the Budget Committee with risk assessment, it fails to overcome the Business Judgment Rule because it does not allege facts showing an unreasonable inquiry. As the Court noted, *Lee* sets forth the common sense requirement that conclusory allegations of an inadequate inquiry

are insufficient in the absence of "'(1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment.'" 1/31 Order at 1 (quoting *Lee*, 50 Cal. App. 4th at 715). The SAC alleges no material facts that additional investigation would have revealed, nor could it: these were AAA-rated investments that even the NCUA ranked among the most conservative and safe at the time. RJN Ex. 10, at 0765-0766. Indeed, had the Budget Committee been given the task of risk assessment, it likely would have duplicated the efforts of the ALCO and the independent expert, RiskSpan: reviewing copious amounts of background data and reaching the same reasonable conclusions.

The SAC does allege that the Budget Committee members knew that investment spreads for MBS securities were tightening and that this fact warranted additional investigation. SAC ¶ 101. But the SAC alleges no facts that connect this piece of information to the process of adopting the budget. Even if Budget Committee members knew it was becoming more difficult to find individual MBS investments that offered, say, a spread of X basis points over MBS issued by Fannie or Freddie, that fact has no connection to the Budget Committee's decision to set WesCorp's overall investment income goal. At most it might militate for or against a particular investment offering a particular spread, but the SAC makes no allegations about any particular investment, much less allege that the Budget Committee ever decided which specific investments to make, or not to make. Indeed, SAC ¶ 94 alleges that WesCorp *reduced* its spreads after 2006 to levels lower than in 2004, 2005 or 2006.

The SAC's Budget Committee allegations also fail to overcome the Business Judgment Rule because they are content-based and allege nothing about the process of adopting the budget. Instead, the allegations take issue with the decisions the Directors made: the level of investment income in the budget and

(with a few unsupportable inferential leaps) the risk implicit in that level of income. As the Court has noted, the Directors "'[i]n performing the duties of a director,' are permitted to 'rely on information, opinions, reports or statements, including financial statements and other financial data' when prepared by various other individuals 'so long as . . . the directors act in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.'" 1/31 Order at 2-3 (quoting Cal. Corp. Code §§ 309(b), 7231(b); *Castetter*, 184 F.3d at 1043-44). This law should focus the Court's inquiry on how the Directors made the decision, what they relied on, and whether such reliance was reasonable: How did the Directors adopt the budget? What did they rely on? What steps should they have taken instead? What would additional inquiry have revealed – not in hindsight, but at the time? The SAC answers none of these questions. It does offer conclusory allegations that the Budget Committee members failed to consult the ALCO or the ALSC (SAC ¶ 102), but then cancels that allegation by alleging that all Directors also "generally attended the ALCO meetings" (SAC ¶ 135) and received presentations on risk (SAC ¶¶ 96, 97, 99). Lacking any allegations of fact demonstrating inadequate processes, the NCUA's new allegations about the Budget Committee are not even minimally plausible. They certainly do not overcome the Business Judgment Rule.

2. The SAC's allegations about Option ARMs fail to overcome the Business Judgment Rule because the SAC does not allege that the Directors knew of but disregarded problems with these securities.

The SAC alleges that the Directors authorized investing in Option ARMs without treating them as a "new" kind of investment and therefore inadequately investigated the risks of Option ARMs. SAC ¶¶ 115-126. These allegations fail to overcome the Business Judgment Rule because the SAC does not plead facts showing that the Directors should have dug deeper given the facts they knew *at*

the time. *See* 12/20 Order at 5-6 (citing *Lee*, 50 Cal. App. 4th at 715). The Court told the NCUA to provide more, stating that these allegations were "irrelevant given the business judgment rule because there are no allegations that the director defendants were aware at the time any investment decisions were made of the *details* underlying the incredibly weak foundation for those securities at the time, or that such information was readily available to them." 1/31 Order at 3 (emphasis in original). In response to this prompting, the NCUA offers only vague allegations that the Directors knew "(1) the 'reset shock' experienced by Option ARM loans increases their credit risk; (2) the credit quality of the Option ARM MBS loan pools was deteriorating; and (3) a drop in housing demand could result in a decrease in real estate values and credit losses on existing Option ARM loans . . . ." SAC ¶ 120. (None of the three is specific to Option ARMs, and only the first is specific to all ARMs, be they Option ARMs or not.) These allegations suggest, at most, that the Directors knew Option ARMs entailed certain risks. SAC ¶ 131. This is a far cry from the Directors being aware of the "details" of the "incredibly weak foundation" of those securities. The SAC faults the Directors for being no more prescient about the future of Option ARMs than the independent rating agencies, the investment banks and the NCUA itself. Such allegations do not meet the test that the Court set out in its 12/20 Order or establish an exception to the Business Judgment Rule.

The SAC also fails to allege that Option ARM MBS comprised an inappropriately large proportion of WesCorp's portfolio. The Court told the NCUA that the allegations related to Option ARM concentration would be relevant only if Option ARM based MBS comprised a large proportion of WesCorp's overall investment portfolio, and even then likely relevant only as to members of the ALCO. 1/31 Order at 3. Yet the SAC alleges that Option ARMs ranged from only 28% to 37% of WesCorp's overall investment portfolio. SAC ¶¶ 121-22. The NCUA alleges no facts to contextualize these numbers as a

"large proportion of not only WesCorp's mortgage-backed securities investments, but also its overall investment portfolio." 1/31 Order at 3. Without such context, the NCUA has not shown that the Directors' investigation was unreasonable under *Lee* given the facts known to them at the time.

Unable to allege that the Directors knew Option ARMs to be unusually weak, or that Option ARMs were a disproportionate part of WesCorp's overall portfolio, the SAC falls back on allegations that the Directors violated some unspecified policy by not treating them as a "new" asset type, from which alleged fact the SAC draws the dubious inference that whatever investigation the Directors did was therefore inadequate, never mind what it was. SAC ¶¶ 115, 119. These vague allegations fly in the face of the ALCO books cited by the SAC. The ALCO books show that each and every investment WesCorp made was first reviewed by the investment staff, then reviewed and approved by the ALCO, then recommended to the Board of Directors and, if approved, monitored periodically thereafter with detailed attention to concentration limits and risk. *See, e.g.*, RJN Ex. 1, at 0013-0020, 0035-0048. The SAC does not even suggest why this method of approval was procedurally inadequate, or how it differed from what WesCorp's policies allegedly required.

The SAC also alleges no facts showing that Option ARM MBS really were "new" within the meaning of the alleged policy. The SAC concedes that WesCorp had purchased MBS since 2002. SAC ¶ 72. A number of institutions offered Option ARMs successfully for decades before they became so popular in the middle of the last decade. Adjustable rate mortgages, and private-label MBS containing ARMs, have been around for decades, received the blessing of Congress and long were viewed as essential to reducing what was deemed the main risks facing financial institutions – interest rate risk and liquidity risk. *See Anchor Sav. Bank, FSB v. United States*, 81 Fed. Cl. 1, 11-20 (2008), *aff'd and remanded*, 597 F.3d 1356 (Fed. Cir. 2010) (explaining how and why Congress

legalized ARMs early in the 1980's and then encouraged the growth of private-label MBS); *see also* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (authorizing ARMs).[3] In hindsight, they may have been abused, or overused, but Option ARMs were not novel or new.

The NCUA's allegations about Option ARMs are nothing more than a slightly different spin on the same old allegations about inadequate investigation, and fail for the same reasons as the other allegations of the FAC and SAC: they are vague and conclusory, and they fail to allege facts that would have been discovered by additional investigation or unreasonable risks known to the Directors at the time, as required by *Lee*.

3. The SAC's allegations about reports on the economy and housing market fail to overcome the Business Judgment Rule because they attack content, not process.

The SAC alleges that, beginning in late 2006, the Directors learned of problems in the housing market by reading discussions of economic and market conditions in the ALCO books. *See* SAC ¶¶ 138-147. The SAC then claims that the Directors acted unreasonably in light of these warnings and did not investigate them adequately. *Id.*

The discussions that the SAC highlights can be summarized as follows: housing is experiencing a slowdown (2006) (SAC ¶ 138); the housing slowdown might cause the economy as a whole to suffer (Q4 2006) (SAC ¶ 139); the

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[3] Title VIII of Garn-St. Germain, the "Alternative Mortgage Transaction Parity Act of 1982," authorized ARMs; it is codified at 12 U.S.C. § 3801 *et seq.* Section 3801(a)(2) contains Congress's finding that ARMs "are essential to the provision of an adequate supply of credit secured by residential property necessary to meet the demand expected during the 1980's . . . ." *See also* Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689, which encouraged private-label MBS. Section 105 of the Act amended the Federal Credit Union Act, 12 U.S.C. § 1757, by adding subsection (15), allowing credit unions to invest in MBS.

housing situation is precarious (end of 2006) (SAC ¶ 140); mortgage delinquencies and foreclosures are rising (Q1 2007) (SAC ¶¶ 141, 142); and subprime is experiencing a "meltdown" (Feb. 2007) (SAC ¶ 142). These statements say nothing about the investments that WesCorp actually made – bearing in mind that WesCorp had started to lighten up on AA (which peaked at 22% of WesCorp's portfolio) back in 2005 and had stopped buying subprime by December 2006. SAC ¶¶ 82, 148.

These allegations also fail for several other reasons:

First, the warnings the SAC cites (usually in part II of the ALCO books) are general discussions about the economy and the housing market that say nothing about the specific investments that the Directors approved. The SAC's so-called "red flags" are nothing more than selectively quoted statements about the economy in general. The SAC makes no attempt, much less a plausible attempt, to connect the ALCO books' high-level discussion of the economy with any specific decision that the Directors made. Such a tactic is understandable; had the NCUA alleged facts about the specific investment decisions that the Directors made, the specific information that the Directors consulted, and the reasons that the Directors made those decisions, it would quickly become apparent that the Directors made reasonable investment decisions based on the best information available at the time. While these decisions did not turn out as hoped, nevertheless, they are precisely the type of decision that the Business Judgment Rule protects

Second, the ALCO books show that the *process* by which the Directors made decisions was much more than adequate. The ALCO books show that the Directors consulted staff about the state of the economy, reviewed each investment individually, and studied hundreds of pages of material each month. *See* RJN Exhibits 1, 4-9. The SAC does not allege that these reports were deficient in any way; it merely quarrels with the decisions made on the basis of

these reports – in short, with content, not process. Like the defendants in *Castetter*, the Directors properly relied upon information prepared by others with expertise (the staff, and RiskSpan). Once again, "[t]he affirmatively-alleged facts about what the Director Defendants *did do* in their roles with WesCorp are not meaningfully different from those the Ninth Circuit considered in *Castetter* and concluded called for application of the business judgment rule." 12/20 Order at 9 (citing *Castetter*, 184 F.3d at 1045). Once again, the SAC does not fault the Directors for the fact that they received information (process) but complains instead about what they did with the information (content).[4] Making such complaints with the benefit of 20/20 hindsight is precisely the kind of second-guessing the Business Judgment Rule is designed to prevent.

The SAC focuses only on the general discussion in part II of the ALCO books. But the Court need not limit its review of these books to the few pages that the SAC chooses to cite. The Court may properly consider the full text of documents mentioned in a complaint and is not bound by a plaintiff's interpretation of them.[5] Viewed in this light, the ALCO books reflect the collection and use of information about the economy at large when considering specific investment decisions. For example, the ALCO book for December 2006

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[4] Even that quarrel is more about timing than substance. The SAC admits that WesCorp lightened up on AA, ceased buying subprime and then ceased buying private-label MBS altogether. It merely wishes that WesCorp had done so sooner than it did. In hindsight, of course.

[5] *See In re Stac Elec. Sec. Litig.*, 89 F.3d 1399, 1405-09 (9th Cir. 1996). Indeed, "in order to '[p]revent[] plaintiffs from surviving a Rule 12(b)(6) motion by deliberately omitting . . . documents upon which their claims are based,' a court may consider a writing referenced in a complaint but not explicitly incorporated therein if the complaint relies on the document and its authenticity is unquestioned." *Swartz v. KPMG LLP*, 476 F.3d 756, 763 (9th Cir. 2007) (quoting *Parrino v. FHP, Inc.*, 146 F.3d 699, 706 (9th Cir. 1998)); *Dreiling v. American Exp. Co.*, 458 F.3d 942, 946 n.2 (9th Cir. 2006) (holding that courts, on a motion to dismiss, "may consider documents referred to in the complaint or any matter subject to judicial notice, such as SEC filings.").

outlined WesCorp's response to deterioration in the housing market: "[L]enders have relaxed underwriting standards to maintain volumes, and credit issues in sub-prime deals, mainly the 2006 originations, are beginning to show in the form of higher delinquency levels. Fortunately our purchase of sub-prime mortgages in 2006 have been minimal compared to prior years. A significant portion of our 2006 purchases have been in Option Arms that have prime or near prime borrowers. Despite the negative press surrounding negative amortization loans their credit performance has been good throughout the year, especially compared to the amount of credit enhancement the rating agencies require." RJN Ex. 6, at 0414. Similarly, the ALCO book for February 2007 stated that "[p]ersistently high delinquencies and losses should result in downgrades of lower rated bonds with slim levels of credit enhancement. Hence, our decision to purchase Triple-A rated structures with higher FICO Alt-A and prime collateral should benefit us in a market with declining credit quality." RJN Ex. 8, at 0618. Far from ignoring the economic trends that the NCUA highlights, the Directors incorporated information about these trends into their investment plans and into their monthly portfolio review. The NCUA can quarrel in hindsight with the content or timing of the decisions the Directors made based on the information they received, but such content-based arguments do not establish an exception to the Business Judgment Rule, within the meaning of *Lee*.

4. The SAC's other "new" allegations simply rehash the inadequate allegations of the FAC.

In addition to the three categories of "new" allegations discussed above, the NCUA offers some additional detail that does nothing more than rehash allegations in the FAC that the Court deemed inadequate. The new details provide yet more hindsight but do not begin to establish any exception to the Business Judgment Rule. These new details fall into three categories:

Lower-tranche AAA investments and capital: The SAC alleges that some

of WesCorp's AAA-rated investments were not from the top tranche. SAC ¶ 84. It also alleges that, while WesCorp increased its capital, it failed to increase its capital enough. SAC ¶ 147.[6] These allegations amount to nothing more than hindsight-fueled disagreement with the content of decisions. The allegations do not describe how and why the Directors made the decision to purchase lower tranche AAA-rated securities, or how those processes were deficient. The allegations offer nothing about how and why the Directors chose a certain level of capital. (The ALCO books reflect monthly consideration of capital levels. *See, e.g.*, RJN Ex. 1, at 0057-0067.) As such, like the other tweaks to the SAC, "these allegations are not significantly different than what were already included in the FAC." 1/31 Order at 2. The SAC does not even allege that higher tranche investments or additional capital would have resulted in fewer losses or avoided insolvency. Hindsight-based arguments such as "AAA-rated was good, but higher tranche AAA-rated would have been better" and "the actual capital increase was good, but even higher increase would have been better" are precisely what the Business Judgment Rule is designed to preclude.

Concentration limits: The NCUA adds some detail about various concentration limits that the Directors either did or did not adopt, but for several reasons the additional detail adds nothing of substance:

- The SAC deems WesCorp's concentration limits too high, but never alleges that WesCorp's investments came near these limits, let alone exceeded them. SAC ¶¶ 111-14. This omission is no accident; WesCorp's MBS typically ran well below the limits. *E.g.*, RJN Ex. 1, at 0039, Ex. 9, at 0689.
- The new allegations completely ignore the ALCO books' detailed tracking of compliance with WesCorp's concentration limits. *E.g.*, RJN Ex. 1, at 0075-

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[6] The SAC fails to allege that WesCorp's capital fell below the regulatory minimum set by the NCUA to be well capitalized. Nor could it; at no time did WesCorp's capital fall below the regulatory standard.

0107. For example, the SAC alleges that the Directors should have tracked both Option ARM MBS and lower tranche AAA rated securities and adopted special concentration limits for them. SAC ¶ 130. These allegations ignore the fact that WesCorp tracked concentration at an even more granular level – by originator, by issuer group, by shelf registration, by servicers, by bond insurer and by state. *E.g.*, RJN Ex. 1, at 039, 0077-0078.

- In substance the new allegations are almost identical to the concentration limit allegations of the FAC, which the Court held "do not satisfy the requirements set forth in *Lee*, 50 Cal. App. 4th at 715." 12/20 Order at 8. *Lee* requires allegations that demonstrate what *at the time* should have alerted the Directors to the need to consider concentration limits for Option ARM MBS or lower tranche AAA-rated MBS. The SAC offers none of this. Nor could it; at the time these top-rated securities appeared as safe as any other highly rated security – and the NCUA has admitted as much. RJN Ex. 10, at 0765-0766. The SAC also fails to allege material facts the Directors would have discovered had they conducted additional investigation into Option ARMs or lower tranche AAA-rated MBS. In hindsight, the NCUA would prefer lower concentration limits. But the SAC offers nothing that made it unreasonable not to have adopted lower concentration limits at the time.

Credit spreads: The SAC adds some detail about the tightening of credit spreads, but the added detail does nothing to establish an exception to the Business Judgment Rule. The SAC alleges that the investment credit spread for WesCorp's MBS tightened, and WesCorp accordingly increased the relative level of risk in its portfolio to earn the same income. SAC ¶¶ 92-93. Even assuming that this is correct as a matter of economics (a heroic assumption, *see* Doc. 113, at 4-7), and is not torpedoed by the allegation that WesCorp actually reduced spreads after 2006, thus decreasing risk (SAC ¶ 94), such allegations: merely describe the risks that WesCorp decided to take; say nothing about the

procedures the Directors used to choose that level of risk; and, accordingly, provide yet another example of content-based hindsight. The SAC does claim that tightening spreads were a "red flag" requiring additional investigation. SAC ¶ 101. But this allegation is wholly conclusory: there is no explanation why a certain level of risk – even a level that changes over time – requires any more investigation than the Directors normally conducted, and no explanation why a shift of a few basis points (hundreds of a percent) was material to anything. The factual allegations about spreads also do not explain what additional facts about the investments additional investigation would have uncovered.[7] Thus, the allegations about spreads fail to satisfy *Lee*. *See* 1/31 Order at 1 (quoting *Lee*, 50 Cal. App. 4th at 715).

Losses: Finally, the SAC adds some detail about WesCorp's alleged losses. It alleges that WesCorp "invested more heavily in private label MBS than other corporate credit unions" and that its failure "threatened the national credit union system." SAC ¶¶ 152, 153. These allegations do nothing to establish breaches by the Directors. They are representative of the improper focus of both the FAC and the SAC: instead of properly alleging facts that might satisfy *Lee*, the NCUA tries to overwhelm the reader with the shock of large losses. Allegations about the size of WesCorp's alleged losses do nothing to establish the Investment Claims.

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[7] The NCUA's "red flags" did not arise until well after some defendants had left WesCorp. Bill Cheney left WesCorp in February 2006 (SAC ¶ 18); Dave Rhamy and Sharon Updike left WesCorp in April 2006 (SAC ¶¶ 21-22). All three left WesCorp before the alleged spreads tightened and the other "red flags" emerged. Indeed, all three left WesCorp before most of the events alleged in the SAC's few substantive allegations that are specific about time. *See, e.g.*, SAC ¶¶ 33-34, 38, 40, 59, 76, 83, 90, 94, 97-102, 122, 131, 138-144, 146, 148-149. Thus, the case against these three Directors must be evaluated without the benefit of any of these allegations.

D. Further leave to amend would be futile.

"Dismissal without leave to amend is proper if it is clear that the complaint could not be saved by amendment." 12/20 Order at 2-3 (quoting *Kendall v. Visa U.S.A., Inc.*, 518 F.3d 1042, 1051 (9th Cir. 2008)). Here, it is clear that further amendment cannot save the SAC. The NCUA has had two chances to plead facts that establish an exception to the Business Judgment Rule but has failed to do so. The NCUA had full-time examiners on site during the years when WesCorp was making these investments, and since taking over WesCorp has had two years more to investigate the facts, and open access to all of the relevant evidence. It is not surprising that the NCUA's investigation has come up short; the numerous and detailed admissions about what the Directors did right show that the Directors did not do anything that might establish an exception to the Business Judgment Rule.

Whether or not to grant leave to amend was a "close call" before (1/31 Order at 3), but now it is clear: the NCUA has no facts that would establish an exception to the Business Judgment Rule. The Directors' motion to dismiss the Investment Claims should be granted with prejudice because further amendment would be futile.

IV. CONCLUSION.

The "new" allegations of the SAC rehash the failed allegations of the FAC and ignore the ALCO books the SAC cites. Like the FAC, the SAC concedes the Directors did many things right. And having conceded this much, the SAC offers nothing more than the hindsight-fueled conclusion that the Directors should have done more, or done it sooner. But as this Court has held, where allegations establish that the Directors acted reasonably under the circumstances known to them and the Business Judgment Rule applies, "California courts have clearly indicated that courts (juries included) should not interfere." 12/20 Order at 9.

Because the SAC repeats the mistakes and deficiencies of the FAC, it should be dismissed. And because the NCUA knew of WesCorp's investment decisions as they were made, and has possessed all of WesCorp's books and records for the last two years, this time the dismissal should be without leave to amend. The Directors – unpaid, uninsured volunteers who never took a dime out of WesCorp for themselves – have suffered enough already from this ill-considered and heavy-handed attempt by a government agency to find a convenient scapegoat, never mind the dubious economics of this litigation or its human cost.

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PILLSBURY WINTHROP SHAW PITTMAN LLP
REYNOLD L. SIEMENS #177956
Email: reynold.siemens@pillsburylaw.com
725 South Figueroa Street, Suite 2800
Los Angeles, CA 90017-5406
Telephone: (213) 488-7100
Facsimile: (213) 629-1033

PILLSBURY WINTHROP SHAW PITTMAN LLP
BRUCE A. ERICSON #76342
Email: bruce.ericson@pillsburylaw.com
GEORGE ALLEN BRANDT #264935
Email: allen.brandt@pillsburylaw.com
50 Fremont Street
Post Office Box 7880
San Francisco, CA 94120-7880
Telephone: (415) 983-1000
Facsimile: (415) 983-1200

By *_/s/ Bruce A. Ericson_*
Bruce A. Ericson

Attorneys for Defendants Robert John Burrell, William Cheney, Gordon Dames, Robert H. Harvey, Jr., James Jordan, Timothy M. Kramer, Robin Lentz, John M. Merlo, Warren Nakamura, Brian Osberg, David Rhamy and Sharon Updike